ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Corbett	Analyst:	Jeff Garnier	Bill Number:	AB 1744
Related Bills:	See Legislative History	Telephone:	845-5322	Amended Date:	1-7-02 & 1-31-02
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Conformity to IRC Section 457 Rollovers and Purchase of Service Credits

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ____________________.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended ____________________.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ____________________.

____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED ____________________ STILL APPLIES.

__X__ OTHER - See comments below.

SUMMARY

This bill would allow public employees both to roll over IRC Section 457 deferred compensation plan proceeds and to purchase service credits with IRC Section 457 deferred compensation plan proceeds.

This bill also contains a provision allowing public employees participating in section 457 plans who retired after January 1, 2002, and before 120 days after the enactment of this bill to change any previous election relating to rollovers and purchase of service credits. This analysis will not address this provision, as the provision does not impact the department.

SUMMARY OF AMENDMENTS

Prior to the January 31, 2002, amendments, the bill would have conformed to most of the pension and educational provisions of the Economic Growth & Tax Relief Reconciliation Act of 2001 (EGTRRA), as well as, numerous other federal provisions. The January 31, 2002, amendments, removed all of the bill's previous provisions and replaced them with the provisions discussed in this analysis.

Board Position:			Department Director	Date
____ S	____ NA	____ NP		
__X__ SA	____ O	____ NAR	Gerald H. Goldberg	03/13/02
____ N	____ OUA	____ PENDING		

PURPOSE OF THE BILL

According to the author's staff the purpose of the bill is to afford public employees with IRC Section 457 deferred compensation plans the same benefits and options as employees with Section 401 deferred compensation plans.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy. Thus, it would be effective immediately, and unless otherwise specified, it would apply to the same periods as the federal provisions, generally for taxable years beginning on or after January 1, 2002 and before January 1, 2011.

POSITION

On March 6, 2002, the Franchise Tax Board voted 2-0 to support this bill, as amended January 31, 2002.

ANALYSIS

Prior to June 2001, California law was in conformity with the federal pension plan provisions. These federal provisions were changed by EGTRRA. California, however, has not conformed to the EGTRRA provisions affecting pension plans. Below is a summary of EGTRRA Sections 641 and 647, relating to section 457 plans, to which this bill would conform. (See Appendix I[1] for a detailed analysis of EGTRRA Sections 641 and 647)

The Internal Revenue Code (IRC) provides for various types of retirements plans. Plans described in the IRC are generally referred to as qualified plans. Section 457 deferred compensation plans are the only type of qualified retirement plans that may be provided by state or local governments and tax-exempt organizations to their employees.

Rollovers

Generally, when an employee in private industry is changing employers they are permitted to rollover their employer sponsored 401(k) plan into a variety of other pension plans. The law is generally permissive for other rollovers of IRAs and section 401(k). In contrast, prior to EGTRRA, Section 457 plans could not be rolled over. EGTRRA permits section 457 plans to be rolled over the same as IRAs and 401(k) plans.

Purchase of Permissive Service Credits

Some qualified plans allow an employee who failed to initially participate in a plan to purchase credit for years of service in the plan as if the employee earned the credit during the years of service. The purchase of permissive service credits in a retirement plan with qualified plan distributions is generally permitted for any employee without triggering any tax consequences. An employee may wish to purchase service credits when an employer offers different retirement plan options (e.g., CalPers did offer Tier 1 and Tier 2 retirement options, a Tier 2 participant can purchase Tier 1 service credits.) Prior to EGTRRA, Section 457 plan distributions could not be used pre-taxed to purchase service credits.

[1] Information for Appendix I derived from the Conference Report for EGTRRA, House Report 107-84.

EGTRRA permits section 457 plans to be rolled over or to purchase permissive service credits without triggering any immediate tax consequences. The rules that pertain to the rollovers or purchase of permissive service credits for other retirement plans (e.g., Section 401(k), traditional IRAs and etc.) generally apply for section 457 plans.

EGTRRA also permits a surviving spouse to roll over distributions to a section 457 plan in which the surviving spouse participates.

<u>THIS BILL</u>

This bill would conform California law to the EGTRRA changes made to the rollover and purchase of permissive serve credits provisions by section 457 plan distributions.

LEGISLATIVE HISTORY

AB 1122 (Corbett, 2001/2002) would conform to all the pension provisions contained in EGTRRA, in addition to other federal provisions. Presently, AB 1122 is in the Senate Appropriations Committee.

AB 1743 (Campbell, 2001/2002) would conform to all the pension provisions contained in EGTRRA, in addition to other federal provisions. Presently, AB 1743 is in the Assembly Revenue and Taxation Committee.

SB 657 (Scott 2001/2002) would conform to all the pension provisions contained in EGTRRA, in addition to other federal provisions. Presently, SB 657 is in the Assembly Appropriations Committee.

SB 1256 (Brulte 2001/2002) would conform to all the pension provisions contained in EGTRRA, in addition to other federal provisions. Presently, SB 1256 is in the Senate Revenue and Taxation Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. Illinois, New York, and Michigan automatically conform to federal law. Therefore, these states are in conformity with EGTRRA changes. Florida does not have a personal income tax. Florida's corporation income tax automatically conforms to federal changes. Massachusetts and Minnesota conform to the IRC with a specified date. The construction of Massachusetts law permits qualified federal retirement plans to be qualified under Massachusetts law. However, Massachusetts has not conformed to the higher deductible or excludible amounts that are allowed under EGTRRA. Minnesota recently passed legislation to conform to EGTRRA.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue effects beginning in 2002-03.

Estimate Revenue Impact of AB 1744 As Amended 1/31/02 [$ I Millions]			
Provision	2002-03	2003-04	2004-05
Rollovers allowed among S. 457 plans, S. 403(b) plans, and qualified plans	minor loss	negl. loss	negl. loss
Purchase of service credit in governmental defined benefit plans	negl. effect	negl. effect	negl. effect

Minor and negligible losses are less than $500,000 and $250,000, respectively. Enactment is assumed after June 30, 2002. Conformity estimates are based on federal projections developed for EGTRRA. The number of recent or soon-to-be retirees who would use funds in a plan to purchase service credit or redeposit prior withdrawals is anticipated to be rather limited and any resulting revenue effect to be negligible.

LEGISLATIVE STAFF CONTACT

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Section	Section Title
641	ROLLOVERS OF SECTION 457 (DEFERRED COMPENSATION RETIREMENT) PLANS

Background

Present law permits the rollover of funds from a tax-favored retirement plan to another tax-favored retirement plan. The rules that apply depend on the type of plan involved. Similarly, the rules regarding the tax treatment of amounts that are not rolled over depend on the type of plan involved.

Distributions from qualified plans

Under present law, an "eligible rollover distribution" from a tax-qualified employer-sponsored retirement plan may be rolled over tax free to a traditional individual retirement arrangement ("IRA"). (All references to IRAs refer only to traditional IRAs. A "traditional" IRA refers to IRAs other than Roth or SIMPLE IRAs or another qualified plan.) An eligible rollover distribution may either be rolled over by the distributee within 60 days of the date of the distribution or be directly rolled over by the distributing plan. The maximum amount that can be rolled over is the amount of the distribution includible in income, i.e., after-tax employee contributions cannot be rolled over. Qualified plans are not required to accept rollovers.

Distributions from section 457 plans

A "section 457 plan" is an eligible deferred compensation plan of a state or local government or tax-exempt employer that meets certain requirements. In some cases, different rules apply under section 457 to governmental plans and plans of tax-exempt employers. For example, governmental section 457 plans are like qualified plans in that plan assets are required to be held in a trust for the exclusive benefit of plan participants and beneficiaries. In contrast, benefits under a section 457 plan of a tax-exempt employer are unfunded, like nonqualified deferred compensation plans of private employers.

Under federal law prior to EGTRRA and under present state law, benefits from a section 457 plan can be transferred to another section 457 plan. Distributions from a section 457 plan cannot be rolled over to another section 457 plan, a qualified plan, a section 403(b) annuity, or an IRA.

Taxation of distributions

Benefits under a section 457 plan are generally includible in income when paid or made available. The federal 10% (2.5% for California) early withdrawal tax does not apply to section 457 plans.

New Federal Law

In general

EGTRRA provides that eligible rollover distributions from governmental section 457 plans generally can be rolled over to any qualified retirement plan, section 403(b) annuity or other governmental section 457 plan or arrangement. Hardship distributions from governmental section 457 plans would not be considered eligible rollover distributions.

Conversely, distributions from any qualified retirement plan, section 403(b) annuity or arrangement are permitted to be rolled over into governmental section 457 plans. The direct rollover rules are extended to distributions from a governmental section 457 plan, and such plans are required to provide written notification regarding eligible rollover distributions. The rollover notice (with respect to all plans) must include the differences between plans, including but not limited to restrictions and tax consequences of distributions and rollovers. Section 457 plans would not be required to accept rollovers.

Amounts distributed from a section 457 plan are subject to the early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from another type of plan. Section 457 plans are required to separately account for such amounts.

Rollover of after-tax contributions

In the case of a distribution from a traditional IRA that is rolled over into a section 457plan, the distribution is attributed first to amounts other than after-tax contributions.

Expansion of spousal rollovers

EGTRRA provides that surviving spouses may roll over distributions to a governmental section 457 plan in which the surviving spouse participates.

California Law

California law has not conformed to the changes made to the section 457plans by EGTRRA.

Section	Section Title
647	PURCHASE OF SERVICE CREDIT UNDER SECTION 457 PLANS

Background

Prior to EGTRRA, a qualified retirement plan maintained by a state or local government employer may provide that a participant may make after-tax employee contributions in order to purchase permissive service credit, subject to certain limits (IRC Sec. 415). Permissive service credit means credit for a period of service recognized by the governmental plan only if the employee voluntarily contributes to the plan an amount determined by the plan. The amount cannot exceed the amount necessary to fund the benefit attributable to the period of service and that is in addition to the regular employee contributions, if any, under the plan.

Prior to EGTRRA, in the case of any repayment of contributions and earnings to a governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan (or another plan maintained by a state or local government employer within the same state), any such repayment is not taken into account for purposes of the section 415 limits on contributions and benefits. Also, service credit obtained as a result of such a repayment is not considered permissive service credit for purposes of the section 415 limits. A participant may not use a rollover or direct transfer of benefits from a tax-sheltered annuity ("section 403(b) annuity") or an eligible deferred compensation plan of a tax-exempt organization or a state or local government ("section 457 plan") to purchase permissive service credits or repay contributions and earnings with respect to a forfeiture of service credit.

New Federal Law

A participant in a state or local governmental plan is not required to include in gross income a direct trustee-to-trustee transfer to a governmental defined benefit plan from a section 403(b) annuity or a section 457 plan if the transferred amount is used to:

1. purchase permissive service credits under the plan, or
2. repay contributions and earnings with respect to an amount previously refunded under a forfeiture of service credit under the plan (or another plan maintained by a state or local government employer within the same state).

California Law

California law has not conformed to the changes made to the purchase of service credits by EGTRRA.